No. 15349

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

JEFFERSON STANDARD LIFE INSURANCE COMPANY, a corporation,

Appellant,

vs.

UNITED STATES OF AMERICA, H. L. BYRAM, County Tax Collector of Los Angeles County, and GEORGE T. GOGGIN, Trustee of STOCKHOLDERS PUBLISHING COMPANY, INC., a corporation, Bankrupt,

Appellees.

APPELLANT'S REPLY BRIEF.

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Preliminary Remarks.

The notable thing about the briefs of the three appellees is that they have not weakened, or indeed seriously challenged, the basic premises upon which appellant rests its case. Specifically, the contentions of appellant which appellees appear to have accepted, or at any rate to be unable to deny, are as follows:

1. Federal law is controlling to determine the priority of secured claims in bankruptcy administration.

2. Federal law is controlling to determine the relative priorities of a federal tax lien and other liens.

3. By federal law, appellant's lien ranks first, the lien of the United States ranks second, and the lien of Los Angeles County ranks third and last.

4. The Bankruptcy Act contemplates a uniform equitable system of priorities in distribution.

5. Where a state law is inequitable, it may be disregarded by a bankruptcy court.

6. The security of a lien creditor should be preserved unimpaired.

7. The order for distribution appealed from is self-contradictory and has no logical basis, but is based on a rule that will make bankruptcy administration arbitrary, variable, uncertain and unpredictable.

8. The order appealed from subordinates appellant's lien to liens to which it is entitled to priority by statute.

9. The order appealed from uses appellant's money to pay the debt owed by the bankrupt to the Los Angeles County Tax Collector.

While the County Tax Collector in his brief says that the order of the District Court is equitable (Br. 10), he has not been able to say how or why it is equitable, nor has he attempted to refute appellant's demonstration that the order is, in fact, arbitrary and inequitable. His argument comes down to an appeal to the necessities of local government, and to the proposition that local taxes by their inherent virtue should be paid ahead of all other claims.

As to the government's brief, we believe it may fairly be characterized as follows. The government does not deny that by federal law, and as declared by the Supreme Court in *United States v. New Britain,*[1] the lien that is first in time is entitled to priority in the absence of special

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[1]347 U. S. 81, 98 L. Ed. 520, 74 S. Ct. 367.

statutory provision to the contrary. Instead, the government seeks to distract attention from the federal rule by capitalizing the Supreme Court's dictum that the United States is not interested in the collection of local taxes, and by embarking on an inquiry into the powers of a bankruptcy court to sell assets free from liens, which we believe to be irrelevant.

The presupposition of both briefs is that it is fair and reasonable that a local tax lien be paid ahead of a prior mortgage lien, any law or equity to the contrary notwithstanding. The County Tax Collector says that the order of the District Court is correct because local taxes must be paid. The Department of Justice says that the order is correct because the United States does not care whether local taxes are paid or not, so long as someone else's money is appropriated for the purpose. We believe that the major premise is not consistent with American notions of due process of law or with the Constitution of the United States or of any state.

Since the briefs of appellees deal with different subjects for the most part, we will discuss them separately.

I.

The Brief for the United States.

As to Circular Priorities.

We submit that in its brief the government has not faced the issues in this case, but has gone off, perhaps inadvertently, into a fruitless inquiry whether the bankruptcy court had the power to order a sale of assets free and clear of liens. The burden of its argument seems to be that the District Court *held* that Jefferson Standard was entitled to first priority in the proceeds of sale, and that since Jefferson Standard did not oppose the order

for sale, it is somehow collaterally estopped from attacking the order for payment from which this appeal is taken.

The issues, as we understand them and attempted to state them in our opening brief, are (1) does controlling federal law give priority to the senior lien claim of appellant under the first in time rule, and require payment of appellant's claim ahead of the junior lien claims of the United States and Los Angeles County; (2) was federal law applied by the District Court; (3) if state law is controlling and entitles the junior lien of Los Angeles County to priority over the senior lien of appellant, should the bankruptcy court have applied state law where it is inequitable to do so.

The government's brief in large part is an exercise in the use of words to obscure the meaning of words. At page 2, and again at page 10, it is stated that the District Court held or ruled that appellant's lien was entitled to first priority, and that the federal tax lien in turn ranked ahead of the county tax lien. It is true that the District Court *said* that Jefferson Standard was entitled to first priority [R. 28], but what it actually *held* was that the claim of Los Angeles County should be paid in full, the claim of appellant should be paid in part, the claim of the United States should be paid in full (to the extent of available assets), and finally the balance of appellant's claim should be paid if surplus assets ever became available [R. 30].

The order the court made is what we are appealing from, and we do not think it can fairly be said that the court's actual order did anything else than subordinate the liens of both Jefferson Standard and the United States to that of Los Angeles County, and subordinate the lien of Jefferson Standard in part to that of the United States,

which is directly contrary to the federal law which the District Court purported to recognize as controlling.

Counsel for the United States (Br. 12) refer to "circular priorities" as though the term were a novelty to them, as well it might be. As we have pointed out (Op. Br. 5-8), the term has no legal significance, but is a semantic device constructed by some courts when faced with conflicting claims of priority to a fund insufficient to pay all lien claims, and to enable them to order the prior payment of local tax liens as "the most equitable solution," thereby circumventing controlling federal law. We have also pointed out (Op. Br. 7, 16-17) that in the case at bar there was no such problem requiring any such "equitable" solution, because the fund was more than sufficient to pay the liens of both Jefferson Standard and Los Angeles County. By command of the statute (I. R. C. 3672), the government stands aside while appellant is paid. A conflict would arise only between the United States and Los Angeles County as to the surplus, and would be easily resolved because the county must yield, as it hesitantly concedes (Br. 2).

The government cites, as it must, *United States v. New Britain, supra,* but omits to quote the relevant part of the opinion,[2] where the Supreme Court said, referring to the universal rule that the lien that is first in time is the first in right:

> "We think that Congress had this cardinal rule in mind when it enacted §3670, a schedule of priority not being set forth therein."

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[2]Quoted in appellant's opening brief, pages 12-13.

Instead the government quotes (Br. 12-13) the part of the opinion in which the Supreme Court rejected the argument advanced against the first in time rule, and which incidentally discredits the rationale of many of the decisions upon which appellees here rely. Counsel seize upon the Supreme Court's remark that the United States is not concerned with the collection of local taxes, as though it were a warrant to ignore the law.

Of course, as the government states (Br. 12, n. 1), the United States is not concerned whether local taxes are paid or not, but it is concerned with the priority of liens where federal tax liens are involved and is also concerned in bankruptcy administration, and there by federal law liens must be given rank in the order of the time of their creation. As a matter of statutory interpretation, does the government really mean to contend that under I. R. C. 3671 the federal lien is satisfied and the United States no longer interested as soon as a fund is merely allocated to a prior mortgage claim, even though all or part of that fund is ordered paid to a local tax claimant whose lien is inferior to that of the United States under I. R. C. 3672? We submit that priority means priority in payment, not priority on paper or in findings of fact and conclusions of law. We further submit that the mandate of Congress and the United States Supreme Court cannot be evaded by a form of words or any such device as "setting aside" a fund equal to appellant's prior lien claim, but then ordering payment to someone else. We do not believe that the legal requirement of priority of payment of a lien claim is satisfied by a mere bookkeeping entry not followed by an actual cash disbursement. It may be that the government is satisfied because the District Court's order has given the

United States priority over appellant to the extent of the county tax claim, but appellant is not satisfied, and we do not believe that the order satisfied the act of Congress which declares that appellant's lien shall be given priority over that of the United States.

Contrary to the government's statement (Br. 8), we think that the United States is interested in whether Los Angeles County receives payment prior to appellant. What the government means is that it is not interested so long as the payment is made *out of appellant's money.* That is a result of which it can approve and which the District Court has called equitable.

The government's argument (Br. 8-9, 14-15) that appellant cannot object to the *order for payment* because it did not oppose the *order for sale* seems to be without merit. It is based in part on a misunderstanding of the record or of the applicable law, or both. At pages 8-9 and again at page 15 of the government's brief it is said that the assets were sold for more than appellant's mortgage claim, so that the trustee could not have abandoned the property. The rule, of course, is that the trustee may and should abandon the property unless its value exceeds the total of *all lien claims,* so that there will be an equity for the estate.

Counsel overlooked the fact that the aggregate lien claims greatly exceeded the value of the property (see Op. Br. 2), so that the sale was of no benefit to the estate. Of course, appellant does not contend "that the referee's order for payment is inequitable in failing to order the trustee to abandon the assets subject to appellant's claim, or by confirming the sale of the assets" (Br. 16). Appellant does not attack the order confirming sale, col-

laterally or otherwise. Appellant does attack the order for payment from which this appeal is taken, and complains that said order is inequitable because it deprives appellant of the security to which it was lawfully entitled, all for the benefit of Los Angeles County and the United States without any possibility of benefit to the general creditors whom alone the court's equitable powers may be invoked to protect, and complains that it is doubly inequitable because the bankruptcy court should not have interfered in the first place.

With that circularity of reasoning which afflicts all those who espouse the doctrine of circular priority in order to attain a desired "most equitable result," the government argues as follows (Br. 15-16): The trustee was *required* to retain the assets and sell them free of liens; the District Court's election to retain or abandon the property was *solely a matter of discretion;* ergo, appellant should have opposed the order for sale and appealed from the order of confirmation, and because it did not do so, appellant is estopped from attacking the order for distribution of the proceeds which subordinated its lien and impaired its security.

The argument is difficult to appreciate. If the sale was required or was a matter of absolute discretion, how could appellant have opposed it? In fact, there was no reason why appellant should have opposed the sale, and there were many reasons why it should not. On the record, it was reasonable to suppose that the proceeds would equal or exceed appellant's claim, although there was little prospect that they would equal the amount of all lien claims. The liens were transferred to the proceeds of sale. Appellant certainly could not have been expected to anticipate that the District Court would

subsequently make an erroneous order for distribution impairing the priority of its claim. Moreover, purposeless opposition to the sale would have gravely prejudiced appellant's right to post-bankruptcy interest on its claim, by exposing it to the charge of having delayed administration of the estate by prolonged and unwarranted litigation.

As to Post-bankruptcy Interest.

The United States has not attempted to impeach the authorities upon which appellant relies in support of its claim to post-bankruptcy interest,[3] nor has it been able to demonstrate any defect in appellant's analysis of this court's own decisions which we think, when rightly understood, are consistent with those authorities and also support appellant's claim to post-bankruptcy interest.

More important, the United States has not shown any equitable reason why appellant's claim to post-bankruptcy interest should be denied. The government does point out (Br. 20) that payment of post-bankruptcy interest to appellant would reduce the amount available for payment to the United States. The force of this argument escapes us, since the federal tax lien is admittedly inferior to appellant's mortgage lien. We have never understood that it is a proper function of a bankruptcy court to insure ratable distribution to secured claimants whose liens have different priorities.

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[3]Cases cited as *contra* (Br. 18, n. 3) are tax claim cases and accordingly are not in point. (See *City of N. Y. v. Saper,* 336 U. S. 328, 93 L. Ed. 710, 69 S. Ct. 554.)

II.
The County Tax Collector's Brief.

The County Tax Collector has not been able to cite any statute or decision to support his contention that the lien for county taxes is entitled to priority over the antecedent contract lien of appellant under the law of California. The authorities cited (Br. 4) are either dicta in decisions concerning the effect of tax sales or tax deeds, or have even less relevance to the subject of priority between tax liens and contract liens. We are not concerned here with the effect of tax sales or tax deeds, or with the relative rank of special assessment and general tax liens, but are concerned solely with the relative priority of contract liens and tax liens.

It is significant that the County Tax Collector has not attempted to meet or overcome the effect of California Civil Code, Section 2897 as the controlling statute, or the decisions cited by appellant (Op. Br. 18-19) applying that statute to determine the priority between contract liens and tax liens.

Rather, the County Tax Collector refers to county taxes as "the life blood of government," and as "the backbone of the financial structure of local government" (Br. 4-5). This is a restatement of the out-moded superior dignity rule. Further, the County Tax Collector speaks as though the taxes on the mortgaged property were an obligation of Jefferson Standard which it ought to have paid (Br. 6-7). On the contrary, the tax was assessed to the owner (as required by Rev. and Tax Code, Sec. 405) and was a lien on the property assessed and on that only (Rev. and Tax. Code, Sec. 2187). Indeed, Article XIII, Section 1 of the California Constitution expressly provides that a mortgage or deed of trust is not property

subject to taxation. The tax in question was not assessed to Jefferson Standard or against property owned by Jefferson Standard, and Jefferson Standard is in no way obligated to pay the tax (*Cf., 3 G Distillery Corp. v. Los Angeles County,* 46 Cal. App. 2d 498, 116 P. 2d 143; *Sherman v. Quinn,* 31 Cal. 2d 661, 192 P. 2d 17).

As to the claimed inherent superiority of the lien for county taxes, we can do no better than to quote the remarks of the late Professor J. C. Peppin, who reviewed the whole subject in his article "Priority of Tax and Special Assessment Liens," (1935) 23 Cal. L. Rev. 264, 265-266, 276:

> "While the general rule ordinarily applied in determining the priority of conflicting liens on the same property is that expressed in the maxim *qui prior est tempore, potior est jure,* the question whether such ordinary rule does or does not apply where one or more of the liens involved are tax liens has been the cause of great divergence of judicial opinion. This divergence of opinion has been brought about by the early adoption of, and the dogged persistence of numerous courts in adhering to, the view that because of the importance of the functions of government and the necessity of raising promptly the revenues necessary to carry out such functions, the obligation to pay taxes is necessarily of much greater dignity and on a much higher plane than ordinary obligations, whether secured or unsecured, and therefore must be accorded some inherent priority over them. The history of the law on this subject has been colored almost completely by the extent to which this principle, styled here for convenience of reference as the 'superior dignity' principle, has been either followed or rejected by the courts. In general,

it will be seen that the principle gained an early foothold and was widely followed for many years, but that later cases have been a series of recessions from it, until today it seems to have been definitely discredited in so far as it is sought to be used as a justification for holding either that taxes are *ex proprio vigore* 'liens' or that tax liens are *ex proprio vigore* 'first' liens, i.e., superior to other liens.

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"The modern view would seem to be eminently sound. According to tax liens a preference over private liens seems to work out badly in practice and to result in frequent examples of injustice. Furthermore, if the prior satisfaction of earlier private liens will have the effect of hampering the government in the collection of its revenues, it would seem to be the peculiar province of the legislature to say so by expressly making taxes a preferred lien, which it unquestionably has the power to do. Its failure to say so would seem to be conclusive evidence that no such hampering effect is deemed by the legislature to exist. For courts to undertake to say that it does exist, when the legislature has not, seems to the writer to be the baldest example of judicial legislation."

Conclusion.

It is all very well that local government be supported and that local taxes be paid. The question is, how and by whom?

Under our American system of government, local taxes should be collected by orderly process of law and by legal and constitutional means in accordance with law—not by judicial legislation, or by judicial fiat thinly disguised as equity.

The legislature of the State of California could, by lawful process, have declared the lien for county taxes paramount and entitled to first priority over all other liens, but it has not done so. The Congress of the United States could have ratified such legislation or passed a similar law of its own, but it has not done so, and instead of so doing has (as interpreted by the Supreme Court) not chosen to enforce the collection of local taxes, but rather has declared all liens entitled to priority in the order of the time of their creation.

Congress is supreme in this field. Where Congress has spoken, its enactments should not be circumvented by an alleged "equitable solution" to a dilemma invoked by the District Court through its disregard of the law; nor can the priority of appellant's lien be evaded by any form of words which results in the use of appellant's money to pay another person's debt.

The order appealed from further impairs appellant's security by denying its claim to post-bankruptcy interest, despite the fact that the security was more than ample and no equitable reason appears why the claim should not have been allowed. In all other Circuits, such interest would have been paid without question.

We submit that the order of the District Court must and should be reversed.

Respectfully submitted,

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